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SUBJECT: ECONOMIC COOLING SEEN AS CHINA TIGHTENS, CONCERNS MOUNT ABOUT U.S. INTEREST RATES, AND STOCKS TUMBLE

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SUMMARY/COMMENT

¶1. (SBU) Hong Kong's 8.2 percent first quarter GDP growth caps off two years of impressive and above-trend economic performance, but this is likely to change quickly. The boost to Hong Kong's economy from China's growth appears set to wane amid determined moves in the mainland to slow loan growth and avoid overheating in specific sectors. Meanwhile, there is widespread concern here that U.S. interest rates will continue to rise. Since the Hong Kong dollar is pegged to the U.S. dollar, this implies further local hikes as well which would cut into the all-important property market as well as the disposable incomes of the many Hong Kongers who have adjustable mortgages. Finally, the stock market here has fallen nearly 9 percent since its recent May 8 peak, and any sustained correction could have a negative wealth effect that would dampen consumer sentiment. END SUMMARY/COMMENT

ANOTHER UPSIDE SURPRISE

¶2. The HKG announced May 23 that Hong Kong's first-quarter year-on-year GDP growth was 8.2 percent, significantly outpacing analysts' forecasts. Below are key year-on-year economic figures from the first quarter economic report released by the HKG; we have provided selected trend commentary:

(percent)

	1Q06	4Q05	2005
-- GDP GROWTH	8.2	7.5	7.3

o Official HKG forecast for 2006 is now 4-5 percent.

	1Q06	4Q05	2005
-- UNEMPLOYMENT	5.2	5.3	6.1(1Q)

o Unemployment is at a 4 1/2 year low.

	1Q06	4Q05	2005
-- INFLATION	1.6	1.3	1.0
-- MERCHANDISE EXPORT GROWTH	14.4	11.4	11.2
-- MERCHANDISE IMPORT GROWTH	14.0	12.0	8.6

o Most Hong Kong trade activity is re-exports involving the

mainland.
o It is significant that exports continue to grow at a double-digit rate against what was already a strong base.

-- SERVICE EXPORT GROWTH	8.9	8.2	8.7
-- SERVICE IMPORT GROWTH	4.8	2.3	2.9

o Service exports include revenues from tourism, an area where growth had recently flattened but is now coming back. Business-related services are also expanding.

-- PRIVATE CONSUMPTION GROWTH	4.5	3.4	3.4

o Reflects sustained optimism, at least until recently, in the face of higher interest rates and energy prices.

-- INVESTMENT SPENDING GROWTH	8.5	8.4	4.1

o Business capital spending is up significantly but construction was down 8.7 percent for the quarter.

LIKELY END OF IMPRESSIVE GROWTH FIGURES

¶3. (U) Since recovering from the SARS outbreak in 2003, Hong Kong's economy has consistently registered growth rates above 7 percent. Several analysts whose views we follow agree that a significant slowdown is inevitable, if only because it is difficult for an advanced economy like Hong Kong's to keep building upon such an impressive expansion. In step with this view, the HKG declined to raise its overall 2006 forecast from its current prediction of 4 to 5 percent, implying that we could see a fall from 8.2 percent in the

first quarter to a run-rate of around 3 percent for the rest of the year.

¶4. (SBU) Three events that have occurred since the first quarter ended are likely to contribute further to Hong Kong slowing down. First, the stock market has tumbled dramatically, with the Hang Seng Index falling nearly 9 percent since May 8, a correction that many saw coming and believe will have a negative effect on consumer sentiment. Second, China recently raised interest rates, imposed administrative controls on lending, and signaled a determination to take further measures as needed to check overheating in sectors like steel and cement. Finally, there is a growing concern here that U.S. Federal Reserve interest rate hikes may not pause as many anticipate, with even the head of the monetary authority recently warning the legislature that "it does not look like a peak is forming yet." This is significant for consumer sentiment in Hong Kong because local rates generally rise and fall in line with U.S. rates as a result of the currency peg. Since many Hong Kongers have adjustable mortgages on their already expensive properties, any hint of rising interest rates generates significant anxiety here.

KEY FINANCE AND TRADE SECTORS VULNERABLE

¶5. (SBU) Standard Chartered China Economist Tai Hui believes that mainland tightening could have a significant effect on Hong Kong's financial markets, particularly as individual firms are hit by specific austerity measures. Citibank Senior Economist Joe Lo shared with us his more broad-based and gloomy assessment, focusing on how Hong Kong's most important sectors are trade facilitation and finance and observing that U.S.- and China-related trends are the primary factors in determining future growth in these areas. Anticipating a slowdown in the U.S. and persistence by China in avoiding economic overheating, Lo predicted that Hong Kong would see significant impacts in trans-shipments and in financial market turnover, both of which are important to the business volumes of many locally-based companies.